THE COMMONWEALTH OF MASSACHUSETTS
BEFORE THE DEPARTMENT
OF TELECOMMUNICATIONS AND ENERGY

BAY STATE GAS COMPANY **D.T.E. 01-81**

TESTIMONY OF TIMOTHY NEWHARD
ON BEHALF OF
THE ATTORNEY GENERAL

April 5, 2002

I. INTRODUCTION

Q: Please state your name and business address.

A: My name is Timothy Newhard. My business address is Office of the Attorney General, Public Protection Bureau, Utilities Division, 200 Portland Street, Boston, Massachusetts 02114.

Q: What is your position with the Office of the Attorney General ?

A: I am a financial analyst with the Utilities Division.

Q: Please describe your educational background.

A: I graduated from the University of Maine at Orono in 1979 with a Bachelor of Science Degree in Engineering Physics. In 1981, I graduated from Northeastern University with a Masters Degree in Business Administration with concentrations in finance and economics. I passed all of the Certified Public Accounting exams in 1985 and successfully completed all of the Chartered Financial Analyst exams in 1991.

Q: Please describe your work experience.

A: I have been employed in the Office of the Attorney General since 1981 as a financial analyst, working on all aspects of utility rate cases. I have advised the Office on policy and technical issues regarding utility matters and testified as an expert witness on various cost of service issues. Most recently, I have been involved in the restructuring of the energy industry in Massachusetts.

Q: Have you presented testimony before the Massachusetts Department Of Telecommunications and Energy, formerly the Department of Public Utilities (the "Department") ?

A: Yes. I have presented testimony before the Department in gas, electric, and telephone cases.

Q: Please briefly summarize the purpose of your testimony in this case.

A: The purpose of my testimony in this case is to discuss the appropriateness of Bay State Gas Company's ("Bay State Gas" or the "Company") proposed gas cost "incentive" mechanism ("GCIM"). My discussion will review the Department's precedents and policies. It will also discuss the effects that the mechanism would have on the Company's customers.

Q: Please provide a summary of your recommendations.

A: The Department should reject the Company's proposed gas cost "incentive" mechanism for several reasons. First, the Company has not shown that the proposed mechanism will have a net benefit for customers. In fact, it is highly likely to have net costs for the Company's customers. Second, the GCIM will change the fundamental principle of the Cost of Gas Adjustment Clause ("CGAC") in which customers and investors expect CGAC to be a "plain-vanilla" pass-through recovery mechanism that recovers prudently incurred actual costs without shareholders profiting or incurring losses. Third, the proposed mechanism will greatly increase the Company's financial risk exposing its shareholders and its customers to the possibility of severe financial harm and the possible bankruptcy of the utility. Fourth, the proposed mechanism will stifle the market for competitive gas supply that the Department has been trying to nurture by providing a service that could and should be provided by the competitive marketplace. Fifth, the proposed GCIM will create incentives for the Company to increase gas supply costs over and above what they would have been without the mechanism. With all of these negatives surrounding the Company's proposal, the Department should specifically reject Bay State Gas Company's proposed gas cost "incentive" mechanism.

Q: How have you arranged your testimony?

A: My testimony is arranged in four sections. The first section provides a description of the Company's proposal. The second section provides the background for the Company's proposal. The third section is an analysis of the Company's proposal based on that background. The fourth section provides my summary and recommendations.

I. DESCRIPTION OF THE COMPANY'S PROPOSAL

Q: Please describe the Company's Gas Cost Incentive Mechanism proposal.

A: The Company proposes to create a new "incentive" mechanism component of the Cost of Gas Adjustment Clause ("CGAC") that it claims will reduce the overall commodity cost of gas for its local gas distribution customers who still rely on the Company for their gas supplies. Generally, Bay State Gas Company's GCIM proposal will allow the Company to enter into all types of financial and physical hedging markets in order to "beat" the indexes of certain gas supply contracts which the Company recovers through its CGAC. The Company proposes to expand the types of costs recoverable through the CGAC to recover the costs of the GCIM program. Furthermore, the Company proposes that customers share in the losses and the gains that will result from the implementation of the GCIM. A complete description of all of the evolving details of the Company's proposal have been provided in the Company's prefiled testimony and its answers to the various information requests issued by the other parties to the case.

II. THE DEPARTMENT'S PRECEDENT AND POLICIES REGARDING THE COST OF GAS ADJUSTMENT CLAUSE AND THE COMPETITIVE GAS SUPPLY MARKET

Q: Please describe the Department's precedent regarding the provision of utility service.

A: The Department has established two basic types of charges which allow gas utilities to recover their costs of providing utility service. The first is the Cost of Gas Adjustment Clause through which the utilities recover their gas supply costs. Since the cost of gas supply can vary significantly over the short-term and since gas costs are a large component of the totality of the costs of doing business for the gas distribution company, the Department has separated gas supply costs from all of the other costs of providing gas service. Those defined gas supply costs are recovered through a separate rate ---- the CGAC, on a reconciling basis. This allows the utilities to pass through prudently incurred costs on a dollar for dollar basis without the shareholders profiting from those rates.

The gas distribution companies recover their non-gas supply costs through the base rates that they charge for gas distribution service. These costs include a return of and on the capital used to provide service as well as the operation, maintenance, and tax expenses.

The Department's long-standing ratemaking policy requires that a utility provide least cost, reliable service. This means that utilities must demonstrate that the costs used to establish the rates that they charge for utility service are not only necessary for providing service, but they must also represent those that would be incurred by an efficient service provider. This policy applies to the costs recovered through the Company's base rates as well as the those costs recovered through the CGAC.

The Department has also introduced competition to the gas supply service that natural gas distribution companies provide. By requiring Local Distribution Companies ("LDCs") to unbundle their rates and facilitate the transfer of customers to market-based suppliers, the Department has indicated its desire to make a fundamental change in the nature of natural gas service business. The LDC utility is no longer the sole provider of gas supply.

The Department has also issued many decisions in an attempt to foster and nurture the competitive market for gas supply. However, notwithstanding all of the efforts to facilitate this market, the competitive market for retail gas supply, like the market for retail electric generation is still in its infancy. More time and more nurturing are needed to facilitate the growth of these markets.

III. THE DEFICIENCIES WITH THE COMPANY'S PROPOSED GCIM

Q: Please summarize your analysis of the Company's proposed GCIM.

A: I believe that the GCIM has many deficiencies that should cause the Department to reject it in totality. These deficiencies are as follows:

(1) the Company has not shown that the GCIM will provide least cost service;

(2) the recovery of GCIM costs through the CGAC improperly changes a fundamental principle underlying the CGAC, that it be a "plain-vanilla" recovery mechanism through which the utility passes its prudently incurred gas supply costs without the benefit of profit or the risk of loss;

(3) the GCIM will force the captured utility customers to support the speculative ventures and risk tolerances of the Company's management;

(4) the introduction of the GCIM will stifle the opening of the competitive gas supply market; and

(5) the proposed GCIM will create improper incentives for the Company that will increase the overall cost of gas supply for customers.

I will discuss each of the deficiencies with the Company's proposal below.

Q: You indicated that the Company has not shown that the GCIM will provide least cost service, is that correct ?

A: Yes.

Q: Please explain that statement.

A: The Company simply assumes that its proposed GCIM will provide net benefits to customers in terms of overall lower gas supply costs, because the Company will have an interest in the outcome as a result of the sharing mechanism. However, the Company did not supply any evidence that the GCIM will actually reduce costs. For that matter, the Company did not even show that customers will break even. In fact, the probability is that customers will incur net costs as a result of the implementation of the program.

Q: Please describe the costs of the GCIM to the Company's customers.

A: The proposed GCIM will necessarily come with some new incremental costs. These costs will include the following:

- an increased cost of capital as the utility puts its assets and earnings at greater risk due to the general potential for losses associated with the GCIM proposal itself as well as the specific risks associated with the new venture into speculating in the derivative securities markets;

- the new transaction costs associated with the firms performing the actual trading of the derivative securities on the boards;

- the new company employees and consultants to manage, facilitate, and carry out trading activities;

- the new computers, and computer software to support the trading activities;

- the new accounting and auditing costs;

- the added insurance costs associated with the traders of and the trading in the financial derivatives;

- the new Department employees to analyze and oversee the prudence of this new activity; and,

- the other regulatory costs associated with the regulatory proceedings including legal fees, transcript costs, copying costs, expert witnesses, and filing fees.

Any hedging technique that the utilities may introduce will come with significant costs that in some cases are easy to measure (e.g. employee salaries and computer software), but in others they are not easily measurable (e.g. increased cost of capital). In either instance, however, those costs must be included in the cost / benefit analysis of any hedging program.

Q: Did the Company quantify any of the benefits of its proposed GCIM ?

A: No. It did not. Although the Company raises the hope of passing on some net reduction in gas supply costs after recovery of all associated costs, it does not and cannot guarantee any net benefits. To the contrary, if one assumes for a minute, and I do not make this assumption, that the GCIM provides incentives for the Company to lower its overall cost of gas, even then, the probability is that the GCIM will cost customers, since one can only expect that the Company will break even on its gas trades.

Q: Why should customers not expect to profit from the Company's trades in the commodity and derivatives markets ?

A: The gas commodity and derivative markets are large and robust. Thus, customers can expect overtime that the Company will only breakeven on its trading activities, before incurring the costs of the trades and other overheads of the trading activities. Including the trading and overhead costs will, on average, result in a net cost to customers for the proposed GCIM.

Q: You indicate that the recovery of GCIM costs through the CGAC changes a fundamental principle underlying the CGAC that it be a "plain-vanilla" recovery mechanism through which the utility passes through its prudently incurred gas supply costs without the benefit of profit or the risk of loss, is that correct ?

A: Yes.

Q: Please explain that statement.

A: The Department's precedent requires, and customers have come to expect, that the CGAC is a simple rate charge for passing through the actual costs of gas supply. They expect the CGAC rate increases only because the cost of gas supply has gone up and not that the Company has incurred financial losses on derivative trading and other hedging activities. This fundamental change in the purpose and nature of this cost recovery mechanism is one that will have considerable unexpected impact on customers. Therefore, the Department should not even consider this proposal without significant pause and a determination whether captive customers are willing to bear the risks and associated costs of the GCIM.

Q: You indicated that the GCIM will force the captured utility customers to support the speculative ventures and risk tolerances of the Company's management.

A: Yes.

Q: Please explain your statement.

A: The costs or benefits that customers might receive as a result of the proposed GCIM would, to a great extent, depend on the risk tolerance associated with highly speculative ventures of the Company and its traders. While the level of comfort with any magnitude of risk exposure may be reasonable for the Company management and its shareholders, it most likely will not be the same level of risk exposure that makes customers comfortable. Regardless of the level of added risk, however, utility customers should not be exposed to any unnecessary incremental risk without their express consent. The local distribution company should be providing a "supplier of last resort" service rather than a competitive supply service.

Q: You indicated that the introduction of the GCIM will stifle the opening of the competitive gas supply market, is that correct?

A: Yes.

Q: Why will the Company's proposed GCIM effect the competitive gas supply market ?

A: The Company's proposed GCIM will hinder the introduction of the competitive gas supply market for two reasons. First, the Company's proposal will artificially lower the cost of gas to default supply customers below their actual costs. This occurs because the Company is not proposing to recover all of the incremental costs of the GCIM through the CGAC. These additional costs include not only administrative costs, but also the increased cost of capital associated with the Company's new risky endeavor that the Company proposes to recover through its base rates. Unless all of the costs of the GCIM are included in the CGAC, the introduction of the GCIM will further stifle gas supply competition by artificially lowering the costs of gas supply that competitors must compete against. To offer the same service, competitive suppliers will have to recover these costs through their prices.

Second, if, as the Company believes, the GCIM provides a value added service, then this type of service is exactly what the competitive market should be providing and not the incumbent monopoly provider of the supply service. The CGAC is, and should remain, a "plain vanilla" service that provides a pass through of prudently incurred least-cost supply.

Q: You indicated that the proposed GCIM will create improper incentives for the Company that will likely increase the overall cost of gas supply for customers, is that correct ?

A: Yes.

Q: Please explain the reasons that the proposed GCIM will create improper incentives for the Company that will likely increase the overall cost of gas supply for customers.

A: The proposed GCIM allows the Company many alternatives to profit through the operations of the mechanism in instances that are not necessarily beneficial to its gas customers. Although I have not identified all of the methods to game the mechanism, I have at least identified a few.

First, since the proposed GCIM establishes the gas contracts, which the Company itself negotiates, as the benchmark for profit sharing, the Company has every incentive to bargain for as high a price as possible on each benchmark contract, thus increasing the cost to customers. So, while the Company may in the future pass on a share of "profits" as a result of beating the costs in these higher priced contracts in its portfolio, if the cost of the Company's overall gas supply portfolio has increased as a result of poor contract negotiations, then there will be a net cost to customers as a result of the GCIM. This added "incentive" feature to the Company's proposal that would result in higher prices for the gas contracts is something that the Department can warn against, but can not practically prevent. Therefore, for no other reason, the Department should reject the

Company's proposed GCIM, since it provides incentives to increase the Company's overall cost of gas supply.

Second, the Company's proposed incentive mechanism determines the profit sharing based on the difference between the benchmark and the cost that the Company is actually able to achieve, rather than trying to achieve the overall lowest cost.

A simple example will clarify the meaning of this consequence. Suppose the Company has the two contracts for gas supply. Assume the benchmark cost of Source A is $1 per mmbtu and the benchmark cost of Source B is $1.25 per mmbtu with all other things being equal. If the Company, for whatever reason, has an opportunity to buy gas from one of those sources at either a price of $0.90 per mmbtu from Source A or $1.00 per mmbtu from Source B, it will naturally chose the $1.00 from Source B. It chooses the $1.00 per mmbtu from Source B, even though the overall cost of the $0.90 per mmbtu from Source A is lower, since the difference between the benchmark price and the actual price is greater for Source B at $0.25 [$1.25 - $1.00] than is the difference for Source A at $0.10 [$1.00 - $0.90]. Therefore, the proposed GCIM does not give the Company an incentive to achieve the overall lowest cost of gas supply, but rather the greatest difference between the high cost of gas and the actual cost it can achieve.

Finally, the GCIM could also adversely affect costs as a result of the Nisource's other business operations. This could include transactions of its production, supply, pipeline, and distribution affiliates which may or may not directly involve Bay State Gas Company. For instance, Nisource could contract to buy gas from a supplier for Bay State Gas at a certain price on the condition that the supplier discount the price of gas it provides to one of Nisource's other subsidiaries whether it be regulated or unregulated. These transactions and those similar to them that shift value from one business to another will be practically impossible for regulators to follow and certainly will be planned to maximize the profits of the shareholders at the expense of customers (to the extent that these affiliate transactions are not occurring already).

IV. SUMMARY AND RECOMMENDATIONS

Q: Please summarize your testimony and recommendations.

A: The Company has not shown, and it will likely not achieve, any net benefits for customers from the Gas Cost Incentive Mechanism that it proposes to include in the CGAC. Furthermore, the Company fails to acknowledge that the proposed GCIM will increase other costs like the cost of capital and the cost of the gas contracts that by themselves could wipe out any potential benefit from the claimed benefits of the mechanism. The GCIM will force captured utility customers to take on new risks and costs that they do not expect and may not want. The proposed GCIM will stifle the market for competitive gas supply that has hardly begun. Finally, the proposed GCIM will create perverse incentives that will raise the overall cost of gas for customers higher than it would have been otherwise.

The Department should maintain the fundamental principle underlying the CGAC that it be a "plain-vanilla" recovery mechanism through which the utility passes through its prudently incurred gas supply costs without the benefit of profit or the risk of loss, since this is what customers and investors have come to expect. If the Company needs to provide this type service that it is proposing with the GCIM, it should use its "expertise" to compete in the gas supply market place with the rest of the competitors who can bring this value-added service through an unregulated subsidiary of Bay State Gas Company's parent – Nisource – so that customers may choose ***if they wish*** to take on the added risk and the added costs of a service that may benefit them by achieving lower costs.

For all of these reasons, I would recommend that the Department reject the Company's proposed GCIM.

Q: Does that conclude your testimony?
A: Yes. It does.